

3. Study the extract and data below and answer the questions that follow.

Iceland

- ❶ Iceland's *per capita* income has been growing at double the OECD* rate since the mid-1990s. It is now the fifth-highest among member countries and more than a quarter above the OECD average. This impressive performance is due to extensive structural reforms that deregulated and opened up the economy, thereby encouraging greater **entrepreneurship**. Strong economic growth has been accompanied, however, by mounting imbalances in the economy. Aggregate demand has increased beyond potential output. As a result, inflation and the current account deficit have become problems. Cuts in personal income taxes, intended as a supply-side policy to enhance efficiency, contributed to inflationary pressures.
- ❷ Inflation has exceeded the official target of 2.5% since mid-2004. The Central Bank has been hesitant in raising interest rates in the past, and has only recently begun to tighten **monetary policy** by increasing interest rates. Monetary policy will need to remain tight until inflation expectations are consistent with the inflation target set by the Central Bank. This is crucial because of the effect that wage increases have in creating cost push inflation. It would also be helpful if members of the government respected the independence of the Central Bank, as this would reinforce the credibility and effectiveness of policy.

* OECD is the Organization for Economic Cooperation and Development (formed in 1961). The members in 2006 were: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

[Source: http://www.oecd.org/document/15/0,3343,en_2649_34569_40158159_1_1_1_1,00.htm, 28 February 2008]

(This question continues on the following page)

(Question 3 continued)

Figure 1: GDP, % increase on a year earlier

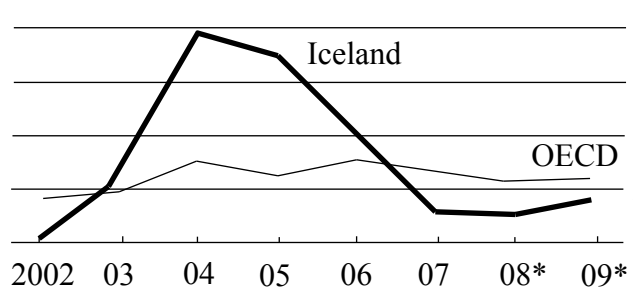


Figure 2: Consumer prices, % increase on a year earlier

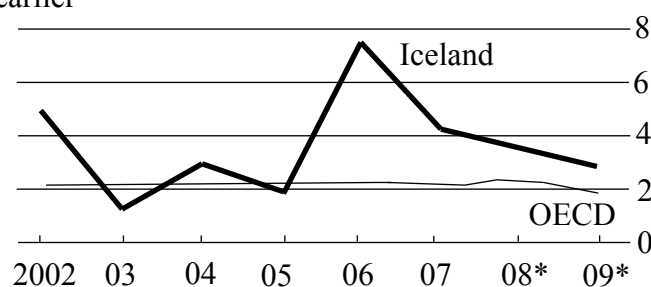


Figure 3: Current account, as % of GDP: Iceland

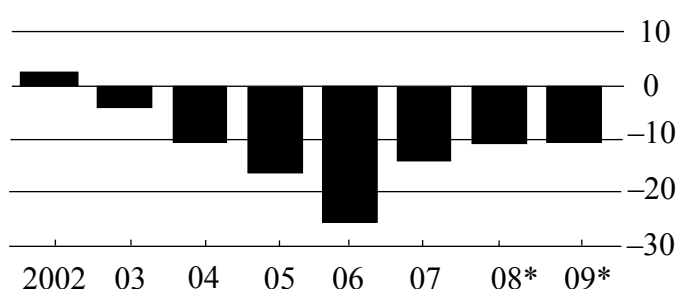
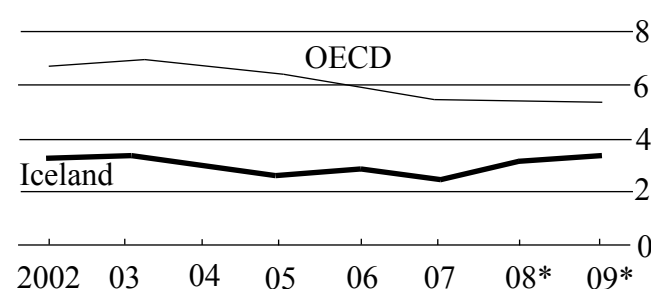


Figure 4: Unemployment, as % of labour force



* Forecast

[© The Economist Newspaper Limited, London, 13 March 2008.]

- (a) Define the following terms indicated in bold in the text:
- (i) entrepreneurship (*paragraph 1*) [2 marks]
 - (ii) monetary policy (*paragraph 2*). [2 marks]
- (b) Using an appropriate diagram, explain the likely effect of aggregate demand increasing “beyond potential output” (*paragraph 1*). [4 marks]
- (c) Using an AD/AS diagram, explain how wage increases create cost push inflation (*paragraph 2*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the consequences for Iceland’s economy if it maintains tight monetary policies. [8 marks]